CASE ANALYSES OF STANDARD ACCOUNTING PRACTICES

By
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A thesis presented in partial fulfillment of requirements for the Sally McDonnell Barksdale Honors College at The University of Mississippi.

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ABSTRACT

The completion of this thesis is due mostly in thanks to ACCY 420, a class designed by the Patterson School of Accountancy and taught by Dr. Victoria Dickinson that gives accounting students a structured process for designing their theses on purposeful accounting topics. During my Junior and Senior years, there was a whirlwind of activity surrounding accounting students: accounting classes step into a new realm of difficulty, internship recruiting begins, and eventually my peers and I departed for multi-month internships. All of that activity left us with far less time to work on our theses than students in other academic arenas.

Luckily, ACCY 420 provided us with an effective process to write our theses. During both semesters of our Junior year, this class would meet once a week, beginning every other week with a new case study addressing an ambiguous situation or problem in financial reporting. In these case studies, we were presented with more complex accounting problems than normally encountered in standard accounting classes. Each case required a large amount of background detail on the company (or companies) being studied in the case and the solution was usually never cut-and-dry. That lack of a "right" answer was perhaps the most helpful part of the class: whereas tests always have one right answer, my peers and I often found that we had come to different conclusions on how to handle certain situations in the case, which was good exposure to how problems are tacked in the real world.

As far as knowledge gained from this class, I feel that ACCY 420 was beneficial for me in multiple areas as I prepare to move into the real world. The first and most

obvious area that I improved in was knowledge of financial reporting as well as the process of reporting those findings using technical skills (Excel) as I wrote my professional reports. As I said before, ACCY 420 presented my classmates and I with contextualized problems that were not so easily solved; there were not only multiple variables in the problem, but also multiple approaches on what those variables meant and how they affected the final solution. Encountering more difficult problems forces you as a student to truly understand the accounting concepts behind the problem; otherwise, you have no groundwork to solve the problem with. In this sense, ACCY 420 absolutely enhanced my understanding of accounting principles in the areas our case studies pertained to. Also, reporting my findings in a professional manner meant using some of the tools in Excel that have always evaded me. As I later found out in my internship, Excel will be my best friend in the coming years, so I was thankful for this class' introduction to its usefulness.

However, my favorite part of the ACCY 420 experience (the part that I believe is most important moving forward in my career) is working on complicated problems with other people, all of whom exercise their critical thinking in different ways. The critical thinking process can be difficult when you are dealing with a problem alone that you do not fully understand; with a team, I was able to bounce ideas off of my teammates and see the problem from other points of view that may have never even crossed my mind. Then, after discovering each person's point of view, we worked together to come to a common agreement on the correct solution, which can also be a process if people are adamant about their answer being the right one. Ultimately, it was this human element of ACCY 420 that I enjoyed the most and believe is the most applicable to my future. No

matter how easy or complicated the problem, accounting is a team effort in every aspect and requires as much social skill as it does technical skill. As I move forward into a career in accounting, I will remember the different team dynamics encountered in ACCY 420 and the lessons I took from those experiences.

Financial Analysis for Potential Investment

Financial Position and Profitability of:

Glenwood Heating, Inc.

(Glenwood Springs, CO)

Vs.

Eads Heater, Inc.

(Eads, CO)

Presented by:

Warren Ball

The University of Mississippi

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Executive Summary

Glenwood Heating, Inc. and Eads Heater, Inc. are two highly comparable businesses selling home heating units in Colorado, functioning under similar economic conditions with identical operations during the year. While both companies have positive qualities that make them attractive potential investments, my analysis has led me to believe that Glenwood Heating would be the better investment choice for our company at this time due to its higher profitability and Earnings per Share, among other qualities. Below, I will discuss certain differentiating financial aspects of each company while also highlighting some of the qualities that I believe make Glenwood a more attractive investment.

Analysis

Glenwood		Eads	
Return on Assets	0.14	Return on Assets	0.1
Return on Owner's Equity	0.4	Return on Owner's Equity	0.34
Earnings Per Share	28.98	Earnings Per Share	22.04

The three ratios listed above deal with these companies' profitability, obviously an important aspect to an investor. The bullet points below explain the meaning and significance of these ratios.

- **Return on Assets (ROA)**: Glenwood is receiving nearly 5% more return on their assets in terms of income than Eads. Both companies' main assets (land, building) are identical; however, Eads has acquired equipment on a capital lease agreement, therefore identifying their equipment as an asset. By identifying the equipment as an asset, Eads "average total assets" increased, but their net income did not, hence Eads' lower ROA. While one could argue that Eads is technically in a more secure position by owning their equipment, I believe that, long-term, Glenwood's rental of equipment will actually work in their favor. We live in a world that is focusing more and more on conserving energy; as a result, energy-related products and markets have become increasingly competitive. It's highly unlikely

that the heaters Eads is currently selling are going to be relevant 8 years from now. Therefore, Glenwood's choice to rent equipment should be viewed as higher flexibility, not lower security.

- **Return on Owner's Equity (ROE)**: This statistic measures the return on stockholders' investments after interest is paid to creditors, a category in which Glenwood leads by 6%. Even with identical amounts of Common Stock invested in each company, Glenwood managed to produce $22,227 more in both Net Income and Retained Earnings than Eads, leading to a higher ROE.

- **Earnings per Share**: As a result of Glenwood's higher Net Income on the year, Glenwood's shares are worth $6.94 more per share than Eads stock, a wide margin for any potential investor. The numbers speak for themselves.

Glenwood		Eads	
Profit Margin	0.23	Profit Margin	0.18
Debt Ratio	0.64	Debt Ratio	0.71

- **Profit Margin**: Glenwood is keeping 5% more of their total sales dollars than Eads, or $22,227 more Net Income. Much like Earnings per Share, this ratio comparison somewhat speaks for itself. If Glenwood and Eads continue to produce identical or even relatively similar amounts of sales, Glenwood's Profit

Margin will result in a company with much more Retained Earnings and better Earnings per Share.

- **Debt Ratio**: Glenwood's lower Debt Ratio brings us back to the company's choice to rent their equipment rather than lease it. Eads is locked in on an 8-year capital lease agreement with an 8% interest rate that will have them paying $16,000 every year. Glenwood, on the other hand, has agreed to 2 years' worth of $16,000 rental payments without indebting themselves to a supplier. Once again, Glenwood's decision to rent equipment works in their favor.

The last item I want to address is each company's cash flow, particularly relating to their cash flows from operations. As you can see below, Glenwood's operating cash flow lost $16,049 more dollars than Eads, which, on the surface, may be concerning; after all, cash is king. However, the charts below will show you that this seemingly negative aspect of Glenwood's operations derives mainly from their choices in GAAP application compared to Eads.

Glenwood Heating Inc.	
Statement of Cash Flows	
For Year Ended December 31, 20X1	
Cash from Operating	
Net Income	$ 92,742
Accounts Receivable	(99,400)
Accounts Payable	26,440
Interest Payable	6,650
Depreciation Expense	19,000
Increase in Inventory	(62,800)
Bad Debt Expense	994
Net Cash from Operating	(16,374)

Eads Heaters Inc.	
Statement of Cash Flows	
For Year Ended December 31, 20X1	
Cash from Operating	
Net Income	$ 70,515
Accounts Receivable	(99,400)
Accounts Payable	26,440
Interest Payable	6,650
Depreciation Expense	41,500
Bad Debt Expense	4,970
Increase in Inventory	(51,000)
Net Cash from Operating	(325)

The three areas to concentrate on are 1) depreciation expense, 2) bad debt expense, and 3) inventory. 1) Eads chose to depreciate their delivery equipment using the double-declining balance method, whereas Glenwood used straight-line depreciation. This choice results in Eads accounting for $22,500 more depreciation, which positively affects their cash flow. 2) Eads estimated their bad debt at 5% of accounts receivable compared to only 1% by Glenwood, resulting in Eads accounting for $3,976 more bad debt expense than Glenwood. 3) Eads used LIFO inventory method and Glenwood used FIFO. Both companies' inventory was valued higher the later it was purchased, which means that Glenwood (using FIFO) ends the year with higher-valued equipment. As a result,

Glenwood's inventory drives their cash flow from operations down by $11,800 more than Eads. All 3 of these factors make Glenwood's cash flow from operations appear much worse than Eads, when in reality Glenwood could simply change their application of GAAP and the cash flows would look much different.

Note: The Appendix below will provide with both Glenwood's and Eads' financial statements, along with all their comparative ratios.

Appendix

- Glenwood Heating, Inc. Financial Statements

Glenwood Heating Inc.

Classified Balance Sheet

December 31, 20X1

Assets			
Current Assets			
Cash		$ 426	
Accounts Receivable	99,400		
Less: Allowance for Doubtful Accounts	994	98,406	
Inventory		62,800	
Total Current Assets			$ 161,632
Long-term Assets			
Land		70,000	
Building	350,000		
Less: Accumulated Depreciation	10,000	340,000	
Equiment	80,000		
Less: Accumulated Depreciation	9,000	71,000	
Total Long-term Assets			481,000
Total Assets			$ 642,632
Liabilities & Owners' Equity			
Current Liabilities			
Accounts Payable		$ 26,440	
Interest Payable		6,650	
Total Current Liabilities			$ 33,090
Long-term Debt			
Notes Payable		380,000	
Total Liabilities			413,090
Stockholders' Equity			
Common Stock		$ 160,000	
Retained Earnings	92,742		
Less: Dividends Paid	23,200	69,542	
Total Equity			229,542
Total Liabilities and Stockholder Equity			$ 642,632

Glenwood Heating Inc.
Income Statement
For Year Ended December 31, 20X1

Sales		$ 398,500
Cost of Goods Sold		177,000
Gross Profit		221,500
Selling and Administrative Expenses		
Bad Debt Expense	994	
Depreciation Expense	19,000	
Other Operating Expenses	34,200	
Rent Expense	16,000	
Total Selling and Administrative Expenses		70,194
Income from Operations		151,306
Other Expenses		
Interest Expense		27,650
Income before Taxes		123,656
Provision for Income Taxes		30,914
Net Income		$ 92,742

Glenwood Heating Inc.
Statement of Retained Earnings
For Year Ended December 31, 20X1

Beginning Retained Earnings		-
Plus: Net Income		92,742
Less: Dividends		(23,200)
Ending Retained Earnings	$	69,542

Glenwood Heating Inc.

Statement of Cash Flows
For Year Ended December 31, 20X1

Cash from Operating	
Net Income	$ 92,742
Accounts Receivable	(99,400)
Accounts Payable	26,440
Interest Payable	6,650
Depreciation Expense	19,000
Increase in Inventory	(62,800)
Bad Debt Expense	994
Net Cash from Operating	(16,374)
Cash from Investing	
Land	(70,000)
Building	(350,000)
Equipment	(80,000)
Net Cash from Investing	(500,000)
Cash from Financing	
C/S	160,000
Dividends	(23,200)
Increase in Notes Payable	380,000
Net Cash from Financing	516,800
Net Cash Provided	$ 426

- Eads Heater, Inc. Financial Statements

Eads Heaters Inc.

Classified Balance Sheet
December 31, 20X1

Assets			
Current Assets			
Cash		$ 7,835	
Accounts Receivable	99,400		
Less: Allowance for Doubtful Accounts	4,970	94,430	
Inventory		51,000	
Total Current Assets			$ 153,265
Long-term Assets			
Land		70,000	
Building	350,000		
Less: Accumulated Depreciation	10,000	340,000	
Equiment	80,000		
Less: Accumulated Depreciation	20,000	60,000	
Leased Equipment	92,000		
Less: Accumulated Depreciation	11,500	80,500	
Total Long-term Assets			550,500
Total Assets			$ 703,765
Liabilities & Owners' Equity			
Current Liabilities			
Accounts Payable		$ 26,440	
Interest Payable		6,650	
Total Current Liabilities			$ 33,090
Long-term Debt			
Notes Payable		380,000	
Lease Payable		83,360	
Total Long-term Liabilities		463,360	
Total Liabilities			496,450
Stockholders' Equity			
Common Stock		$ 160,000	
Retained Earnings	70,515		
Less: Dividends Paid	23,200	47,315	
Total Equity			207,315
Total Liabilities and Stockholder Equity			$ 703,765

Eads Heaters Inc.
Income Statement
For Year Ended December 31, 20X1

Sales		$ 398,500
Cost of Goods Sold		188,800
Gross Profit		209,700
Selling and Administrative Expenses		
Bad Debt Expense	4,970	
Depreciation Expense	41,500	
Other Operating Expenses	34,200	
Rent Expense	-	
Total Selling and Administrative Expenses		80,670
Income from Operations		129,030
Other Expenses		
Interest Expense		35,010
Income before Taxes		94,020
Provision for Income Taxes		23,505
Net Income		$ 70,515

Eads Heaters Inc.
Statement of Retained Earnings
For Year Ended December 31, 20X1

Beginning Retained Earnings	-
Plus: Net Income	70,515
Less: Dividends	(23,200)
Ending Retained Earnings	$ 47,315

Eads Heaters Inc.

Statement of Cash Flows
For Year Ended December 31, 20X1

Cash from Operating	
Net Income	$ 70,515
Accounts Receivable	(99,400)
Accounts Payable	26,440
Interest Payable	6,650
Depreciation Expense	41,500
Bad Debt Expense	4,970
Increase in Inventory	(51,000)
Net Cash from Operating	(325)
Cash from Investing	
Land	(70,000)
Building	(350,000)
Equipment	(80,000)
Leased Equipment	(92,000)
Net Cash from Investing	(592,000)
Cash from Financing	
C/S	160,000
Dividends	(23,200)
Increase in Notes Payable	380,000
Increase in Lease Payable	$ 83,360
Net Cash from Financing	$ 600,160
Net Cash Provided	7835

Glenwood & Eads Comparative Ratios

	Glenwood	**Eads**
Liquidity		
Current Ratio	$\frac{426+99400+62800}{26440+6650} = 4.8$	$\frac{7835+99400+51000}{26440+6650}$ = 4.73
Acid-Test Ratio	$\frac{426+98406}{26440+6650} = 2.99$	$\frac{7835+94430}{26440+6650} =$ 3.09
Accounts Receivable Turnover	$\frac{398500}{98406} = 4.05$	$\frac{398500}{94430} =$ 4.22
Days to Collect Receivables	$\frac{365}{4.05} = 90.1$	$\frac{365}{4.22} =$ 86.5
Inventory Turnover	$\frac{177000}{62800} = 2.82$	$\frac{188800}{51000} =$ 3.7
Days to Sell Inventory	$\frac{365}{2.82} = 129.43$	$\frac{365}{3.7} =$ 98.65

Operating Cycle	$90.1 + 129.43 = 219.6$	$86.5 + 98.65 =$ 185.1

Profitability

Gross Profit Margin	$\frac{398500-177000}{398500} = .56$	$\frac{398500-188800}{398500} = .53$
Profit Margin	$\frac{92742}{398500} = .23$	$\frac{70515}{398500} =$ .18
Return on Assets	$\frac{92742}{642632} = .14$	$\frac{70515}{703765} =$ .1
Return on Equity	$\frac{92742}{229542} = .4$	$\frac{70515}{207315} =$ .34
Earnings per Share	$\frac{92742}{3200} = 28.98$	$\frac{70515}{3200} =$ 22.04
Debt Ratio	$\frac{413090}{642632} = .64$	$\frac{496450}{703765}$ = .71
Times Interest Earned	$\frac{151306}{27650} = 5.47$	$\frac{129030}{35010}$ = 3.69

Financial Analysis for Potential Investment

Molson Coors Brewing Company

Profitability and Earnings Persistence

Presented by:

Warren Ball

The University of Mississippi

Summary

As a potential investor in Molson Coors Brewing Company, the company's efficiency, profitability, and resulting future stock prices are all important factors in our investment decision. One of the main concentrations in our analysis of Molson Coors was differentiating between the company's operations and non-operations related items, from non-operating assets to discontinued operations. A company's income from operations is the biggest driver behind its stock prices and profitability; with this knowledge, we analyzed what portion of Molson Coors' income is expected to reoccur (persistent income) as well as the company's return on their operating assets (efficiency). Below, I will highlight the 3 main factors that I believe make Molson Coors an attractive investment opportunity.

- Effective Tax Rate: The United States Federal Statutory rate for income taxes is 35%, roughly 19% higher than Molson Coors' effective tax rate. This discrepancy derives from Molson Coors' tax planning as well as their foreign businesses, which operate under a significantly lower income tax rate than the U.S. Although Molson Coors' operations and general effectiveness as a company do not positively affect their tax rates, their lower tax rates will have a noticeable effect

on their income. **Caution**: Do not be alarmed by the fact that our calculated effective tax rate is about 3% higher than previous years for Molson Coors. In our estimations of future tax rates, we were conservative in our elimination of certain unpredictable elements, namely unrecognized tax benefit, change in valuation allowance, and "Other, net." We also expect foreign tax rates to remain consistent, and Molson Coors will continue to reap the benefits from these cheaper tax rates. See part **J)** in the appendix for further detail.

- Increase in both Operating Profit Margin and Net Operating Asset Turnover: Relevant financial ratios to a company's operations can be very useful in identifying a company's efficiency and profitability; for Molson Coors, those ratios are operating profit margin and net operating asset turnover. Because of a higher net operating profit after tax in 2013, Molson Coors was able to increase their operating profit margin by 1.1%. We also saw net operating asset turnover increase from 3.56 to 4.82, or a 26% increase. Molson Coors was able to increase their turnover during the year of 2012-2013 by producing $384.6 Million more in sales even with $330.7 Million less in average net operating assets. Both of these ratios speak to increased profitability and efficiency within Molson Coors, and both ratios play directly into our most important item in supporting a Molson Coors investment.
- Return on Net Operating Assets (RNOA): Earlier in our summary, we mentioned that operating income is the biggest driver of profitability and stock price increases. RNOA is the perfect ratio to quantify this relationship, and for Molson Coors RNOA indicates an improving company with stability. First, their RNOA

increased **22.3%** from 2012 to 2013, close to a 25% improvement in operating efficiency. Secondly, Molson Coors' RNOA only dropped 6.2% after eliminating non-persistent income from the equation. Just over 91% of Molson Coors' income after tax derives from persistent income, a great indicator of current stability in the company's revenue flows.

Ultimately, I believe that these 3 factors are the most important in supporting an investment in Molson Coors Brewing Company. However, if greater detail is needed or wanted for making this decision, the appendix below will provide it.

Appendix

The answers below provide detailed explanations to questions provided in our case. This appendix will 1) highlight important elements in evaluating Molson Coors Brewing Company's future profitability and 2) give you a more thorough, step-by-step analysis of why we chose to invest in Molson Coors. Each letter responds to a question in our case.

A) The major classifications on an income statement are: sales, gross profit, expenses (controllable and fixed), profit, and loss. Each one of these income statement elements is crucial to the process of determining a company's income, including their income from operations.

B) Classified income statements permit users to assess the amounts, timing and uncertainty of future cash flows. Prediction of future cash flows is key to any potential or current investor's financial interest in the company.

C) Financial statement users would be interested in persistent income because it is the portion of a company's income that can be fully expected to reoccur the following year. Considering that investments are made based on potential future profitability, persistent income is obviously important.

D) Comprehensive income includes all changes in equity during a period except those resulting from an investment by an owner or a distribution to owners. Net income includes all changes in owner's equity.

E) Net sales $=Sales - excise\ tax$. Excise taxes inflate the total sales number. If Molson Coors chose not to subtract excise tax from sales, their sales numbers would be inflated by an average of 1,715 million per year, subsequently decreasing their profit margin.

F) Special items are gains or expenses that a company believes are not indicative of their core operations. These items are listed separately because it is likely that they will not reoccur. While there are a couple of items that seem unrelated to operations (flood losses, for example), for the most part Molson Coors' assessment of special items is accurate. In Molson Coors' case, some of these items include:

- Expenses from restructuring employee severance programs
- Flood losses
- Asset impairment

G) "Other income" related expenses and gains are completely unrelated to operations, whereas special items are non-recurring operations-related items.

H) Comprehensive income totals 760.2 million for the year compared to 572.5 million in net income. The 188.3 million in additional income attributed to comprehensive income stems entirely from non-operating gains, such as foreign currency and pension adjustments.

I) There are 3 statements on Molson Coors' income statement that we considered non-persistent:

- Special Items: they may still exist next year, but the future amounts of these items are undeterminable.

- Income/losses from discontinued operations.

These items are self-explanatory. - Income/losses from non-controllable interests: like special items, non-controllable interests will probably affect the company next year, but there is no accurate way to determine these amounts.

J) Elements 1-4 are consistent tax rates that can be expected to reoccur at similar values to previous years. Unrecognized tax benefit, change in valuation allowance, and "other" taxes (elements 5-7) are unpredictable both in amount and existence for future years. We considered eliminating the unpredictable taxes from our effective tax rate but ultimately determined that eliminating these elements would probably result in an undervaluation of tax expenses for the company. Instead, we averaged the amounts of each element (predictable and unpredictable) and added these totals up to create a new effective tax rate.

-**Note**: Foreign tax law rate was not averaged because its 2012 total was not indicative of future rates: Serbia's change in foreign policy resulted in a temporarily 5% higher corporate income tax rate. Instead, we used the 2013 foreign tax law rate.

Molson Coors Brewing Company Effective Tax Rate	
Federal Statutory Income tax rate	35%
State income taxes, net of fed. benefits	1.40%
Effect of foreign tax rates	-24.40%
Effect of foreign tax law	0.50%
Effect of unrecognized tax benefits	0.50%
Change in valuation allowance	2.25%
Other, net	1%
Effective Tax Rate	16.35%

K) Our calculation of Molson Coors' persistent income can be found in the chart on the next page. We used our effective tax rate calculated in **J)** to tax these items. Also, we are told that discontinued operations, special items, and other income are all nonrecurring items.

Molson Coors Brewing Company and Subsidiaries Consolidated Persistent Income Statement (In Millions)			
	2013	2012	2011
Sales	5999.6	5615	5169.9
Excise taxes	-1793.5	-1698.5	-1654.2
Net Sales	4206.1	3916.5	3515.7
Cost of Goods Sold	-2545.6	-2352.5	-2049.1
Gross Profit	1660.5	1564	1466.6
Marketing, General, Admin exp	-1193.8	-1126.1	-1019
Equity Income in Miller Coors	539	510.9	457.9
Operating Income	1005.7	948.8	905.5
Income Tax Expense	-164.43	-155.13	-148.05
NI from Continuing Operations	841.27	793.67	757.45
Persistent Income		797.46	

1-i) We determined that special items, discontinued operations, and other income are all non-operating items. The only other item we considered as possibly non-operating was non-controlling interest; however, because the operations of subsidiaries of Molson Coors produced this income, we classified it as an operating item.

1-ii) Note: Other income and special items are both listed at "before tax" on the income statement; for these items, we will apply the company's three year marginal tax rate of 12%. Discontinued operations are listed as "after tax" and remain the same as previously listed on the income statement.

Total After Tax Amount of Nonoperating Items Molson Coors Brewing Company and Subsidiaries (In Millions)		
	2013	2012
Special Items	-176	-71.63
Other Income	-133.06	-242.26
Discontinued Operations	2	1.5

1-iii)

$$Net\ Operating\ Profit\ After\ Tax$$
$$= N/I\ before\ effects\ of\ nonoperating\ items\ post\ tax$$

$2013 = 567.3 + 176 + 133.06 - 2 = 874.36$ Million

$2012 = 443 + 71.63 + 242.26 - 1.5 = 755.39$ Million

M-i)

Non-operating Assets

Investment in Miller Coors: investment in another company may provide Molson Coors with cash, but it is not a part of operations.

Affiliate: Like the investment in Miller Coors, affiliates provide return on investments but do not relate to operations.

Goodwill & other intangibles: Intangible assets produce long-term value and may derive from operations in some cases; however, they are not essential to operations.

Non-operating liabilities

Hedging instruments: hedging instruments are used to "hedge" the risk of changes in fair value of liabilities and assets. This is an equity related item and is not part of operations.

Discontinued Operations: Self-explanatory. This item is no longer operating.

Long-term debt: The obligation pay off a long term debt is not part of current operations and is therefore excluded.

Pension: Post-retirement payments are clearly not part of operations.

Derivative Hedging: See "hedging instruments" above.

Discontinued Operations: This is a long term version of previously listed discontinued operations liability.

Short term debt: This is the current portion of the company's long term debt. Even though it is a current liability, it is still not part of operations.

M-ii) To find the "net operating assets" amount, we simply subtract the companies operating liabilities from their operating assets, all listed above.

Molson Coors Brewing Company Net Operating Assets (In Millions)		
	2013	2012
Operating Assets	3799	4040.3
Operating Liabilities	-2552.8	-2463.4
Net Operating Assets	1246.2	1576.9

N) $2013\ \text{RNOA} = \frac{874.36}{1246.2} = 70.2\%$ $2012\ \text{RNOA} = \frac{755.39}{1576.9} = 47.9\%$

Note: See case guide for definition of Return on Net Operating Assets

O) $$\textbf{Operating Profit Margin} = \frac{\textbf{net operating profit after tax}}{\textbf{sales}}$$

$2013 = \frac{874.36}{5999.6} = 14.6\%$ $2012 = \frac{755.39}{5615} = 13.5\%$

$$\textbf{Net Operating Asset Turnover} = \frac{\textbf{sales}}{\textbf{net average operating assets}}$$

$2013 = \frac{5999.6}{1246.2} = 4.82$ $2012 = \frac{5615}{1576.9} = 3.56$

P) Persistent income is a better predictor of future return on investment. Why? Profit from operations is the main driver of stock price, and persistent income provides users with a better picture of a company's future income than net profit after tax. This also results in a more accurate RNOA calculation. So, even though RNOA calculated with persistent income is 6.2% lower than RNOA from net profit, this is a much more accurate depiction of Molson Coors' future income.

$$2013\ \text{RNOA (Persistent Income)} = \frac{797.46}{1246.2} = 64\%$$

Golden Enterprises, Inc.

Statement of Cash Flows Analysis

By: Warren Ball III

The University of Mississippi

Executive Summary

The purpose of this report is to give you a more detailed look into how we created Golden Enterprises' 2013 indirect statement of cash flows. Below, you will find answers to each question provided in our case, including information regarding the statement of cash flows' different elements as well as the statement's relation to the company's balance sheet. This statement of cash flows provides investors and creditors with information relating to Golden Enterprises' liquidity and short-term solvency, as well as their immediate profitability.

A) The income statement includes all revenues and expenses, including transactions that don't involve cash exchanges. The statement of cash flows provides information about a company's cash receipts and cash payments during a period. These cash exchanges fall under 3 categories: operating, investing, and financing activities.

B) There are 2 methods for preparing a statement of cash flows: direct and indirect. The direct method includes all cash receipts and expenses listed step-by-step in the operating section, such as "cash from customers" and "cash paid to suppliers." The indirect method simply starts the operating section with net income and then adjusts this total by adding/subtracting revenues and expenses that don't involve cash. As you can see by looking at Golden Enterprises' 2012 statement of cash flows, Golden Enterprises uses the indirect method, starting with net income.

Companies almost always use the indirect method for 2 reasons: 1) net income provides a better picture of a company's day-to-day transactions than do cash exchanges; 2) the indirect method is much easier to prepare; imagine transcribing the thousands of cash transactions that a corporation sized-company has every year.

Here are a couple of examples for adjusting net income. Say that Golden Enterprises' accounts receivable have decreased by $1,000. In order for this to happen, someone has to pay the company $1,000 owed, and this transaction is not recognized on an income statement; therefore, it must be added to net income. On the other hand, say that Golden Enterprises purchases $1,000 in prepaid insurance. Technically this prepaid insurance is an asset, but the company paid $1,000 to acquire this asset, so the amount is subtracted from net income.

C) 1) Operating: this section covers a company's cash position from operations.

2) Investing: this section usually relates to fixed assets, such as PPE and losses/gains from other investments.

3) Financing: this section deals with equity activities and long-term liabilities: bank loans, loan repayments, debt and equity offerings, and dividends.

D) The operating section of the statement of cash flows is going to involve every day transactions in business, which will include accounts like accounts receivable/payable, prepaid expenses (prepaid insurance), inventories, and cash. The investing section involves PPE and other fixed assets. The financing section includes equity related activities and long-term liabilities.

E) Cash equivalents are short-term, highly liquid investments that will mature in 3 months or less. For Golden Enterprises, an example of this type of account would be "checks outstanding in excess of bank balances."

F) The convenience of net income actually comes from the fact that it is accrual based. By automatically covering every transaction the company has made, the only work left to do is adjust the total by getting rid of transactions that don't include cash. The indirect method saves the time and effort of specifically listing every cash transaction that a company makes.

G) See end of report for Golden Enterprises statement of cash flows (page 4).

H) No, depreciation expense does not directly or "actually" generate cash for Golden Enterprises. However, depreciation occurs when the company's plant assets are used to produce goods or services that will eventually generate cash; so, indirectly, depreciation does relate to cash.

I)

	2013	2012
Net Income	$1,134,037	$2,207,623
Cash from operating activities	$4,607,029	$5,747,290

Net income decreased by about 51% from 2012 to 2013, but net cash from operating activities only decreased by about 20%. How can this be? First, go to the income statement and notice that Golden Enterprises' gross margin was roughly 1 million greater in 2013 than in 2012, suggesting increased productivity for the company; unfortunately, this increased productivity was not reflected in net income, a discrepancy stemming mainly from 2 accounts: 1) the company

incurred just over $140,000 more in "other" expenses in 2013 due to less "gain on sale of plant assets" and more interest expense; 2) selling, general and administrative expenses increased by over $2.5 million from 2012 to 2013, an expense that does even directly relate to production. Both of these factors contribute heavily to Golden Enterprises' decrease in net income.

The decrease in net cash from operations can also be easily explained. In 2013, Golden Enterprises paid off over $900,000 more of their accounts payable than they did in 2012; although this payment decreases the company's liability, it also immediately decreases the company's net cash from operations by close to $1 million.

J) Golden Enterprises has increased their productive capacity over the last 3 years. This increase in capacity can be explained by viewing the PPE and depreciation accounts. Over the course of both the 2012 and 2013 fiscal years, Golden Enterprises invested in $9,364,086 of PPE while accumulating only $6,842,093 of depreciation. As a result of their investments, the company's net sales increased by over $1.1 million from 2012 to 2013. As long as the company continues to increase the net worth of its PPE, the company will also have the potential for greater productive capacity.

K) There are 3 routes that Golden Enterprises could take for financing this investment: debt financing, equity financing, or increased productivity (net income). Although Golden Enterprises does not currently have the cash flow to cover a $5 million investment, the company has multiple characteristics that could suggest greater capacity for capital expenditures. Golden Enterprises has

consistently repaid and issued their debt over the past 2 years, suggesting both good credit and dependability; for these reasons, debt financing appears to be a viable option for Golden Enterprises, should the company's owners entertain the idea (debt financing). Golden Enterprises also has good potential for income growth in future years due to their continual investment in PPE (increased net income). Although Golden Enterprises has not issued any common stock dating back to June 3, 2011, equity financing could also potentially be an option (equity financing). Of these 3 options, debt financing and increased productivity appear to be the most viable options.

Golden Enterprises Inc. Statement of Cash Flows For the Fiscal Year Ended May 31st, 2013	
Operating Activities	
Net Income	$ 1,134,037
Adjusted to reconcile NI to net cash	
Depreciation	$ 3,538,740
Deffered Income Taxes	$ (185,939)
Gain on sale of assets	$ (61,040)
Change in receivables	$ 106,367
Change in inventories	$ 200,985
Change in prepaid expenses	$ 200,137
Change in cash surrender value of insurance	$ 62,906
Change in other assets- other	$ (191,298)
Change in accounts payable	$ (1,216,399)
Changes in accrued expenses	$ 954,938
Changes in salary continuation plan	$ (49,774)
Changes in accrued income taxes	$ 113,369
Net cash from operating activities	**$ 4,607,029**
Investing Activities	
Purchase of new PPE	$ (4,149,678)
Proceeds from sale of equipment	$ 74,514
net cash from investing activities	**$ (4,075,164)**
Financing Activities	
Proceeds from debt	$ 38,361,199
Debt repayments	$ (38,287,529)
Change in checks outstanding in excess of bank balance	$ (267,501)
Purchase of treasury stock	$ (6,860)
Cash dividends paid	$ (1,467,879)
net cash from financing activities	**$ (1,668,570)**
Net decrease in cash and cash equivalents	$ (1,136,705)
Cash and cash equivalents at beginning of year	$ 1,893,816
Cash and cash equivalents at end of year	**$ 757,111**

***Note**: all adjustments made to net income can be found by viewing the differences between each relevant t-account's beginning and ending balance. These t-accounts can be found on page 5 of our case. The only t-account included in the statement of cash flows that is not listed among the other t-accounts is "gain on sale of plant assets," which was

found by determining the difference between the sold fixed assets' cash value and accumulated depreciation.

Pearson plc—Accounts Receivable

Accounts Receivable Analysis of Pearson

Presented by:

Warren Ball

The University of Mississippi

Executive Summary

Pearson is an international company headquartered in London, England with businesses in education, business information and consumer publishing. Pearson shares trade in London and New York, operates in more than 60 countries, and prepares its financial statements in accordance with IFRS. Analysis of Pearson's financial statements in the items listed below will help you understand a number of concepts, including: accounts receivable terminology, the use of contra accounts, and the use of an aging schedule to estimate uncollectible accounts. You will also learn how to calculate and analyze accounts receivable turnover and average collection period information.

A) An account receivable is an oral promise of a purchaser to pay for goods or services rendered by the supplier. A receivable is a claim held against a customer or others for money, goods, or services. Accounts receivable can also be referred to as trade receivables.

Dr. Account receivable (A/R)

Cr. Sales revenue

B) An account receivable is a short-term extension of credit usually collected within 30-60 days. A note receivable is a written promise to pay a sum at a future date. A

note receivable may arise from sales, financing, or other transactions, and it can be either short or long term.

C) A contra account is a valuation account whose normal balance is opposite of the normal balance of the account to which it relates. The two contra accounts listed on Pearson's trade receivables are 1) provision for bad and doubtful debt and 2) provision for sales returns. Provision for bad and doubtful debt is an estimation of receivables that will be uncollectible; provision for sales returns estimates the amount of sales that will be returned. In the process of estimating these contra accounts, managers might consider past years' amounts in these accounts, as well as the reliability of both their current customers and their current product.

D) The percentage of sales procedure, also known as the income statement approach, takes a predetermined percentage of sales and estimates that amount to be the balance in doubtful accounts (provision for bad and doubtful debt). The aging-of-accounts procedure (balance sheet approach) increases the uncollectible percentage of a receivable as more time passes because payment becomes less likely. For the percentage of sales method, managers will need the amount of net credit sales and the percentage of that amount that the company estimates to be uncollectible; the amount will then be added to the existing allowance for doubtful accounts amount (if any exists). For the aging-of-accounts procedure, managers need the percentage of A/R deemed uncollectible multiplied by the net A/R. The difference between the number found and the company's beginning allowance amount gives us the company's bad debt expense for the year.

E) Even though some sales are uncollectible, eliminating uncollectible accounts would actually be a bad idea for sales. If credit policies are too strict, there will be lots of unnecessarily lost sales. So, managers have to weigh the risk of bad debts versus lost sales in order to determine company policy on extending credit. Also, for an international company like Pearson with a large client base, it is hard to individually judge customers on their reliability; writing off receivables is just part of business.

F)

i)

	Provision for Bad and Doubtful Debts (in millions)			
1)			£	72.00
2)	£	5.00		
3)			£	26.00
4)	£	20.00		
5)			£	3.00
			£	76.00

1) 72 million- beginning balance

2) Exchanges- changes in valuation due to currency translation

3) Income Statement movements- bad debt expense resulting from estimation of uncollectible credit sales

4) Utilised: this is the amount of bad and doubtful debt expense that the company wrote off when accounts were written off (Dr. provision for bad and doubtful debt; Cr. A/R).

5) Acquisition through business combination- When combining with another business, the other company's A/R's and bad debts are taken on as well.

ii)

1) Dr. Bad and doubtful debt expense (I/S) 26 million

Cr. Provision for bad and doubtful debts (B/S) 26 million

2) Dr. Provision for bad and doubtful debt (B/S) 20 million

Cr. Accounts Receivable (B/S) 20 million

iii) Provision for bad and doubtful debt expense will normally be included in operating expenses, specifically selling, general and administrative expenses.

G)

i)

	Provision for sales returns (in millions)			
1)			£	372.00
2)			£	425.00
3)	£	443.00		
			£	354.00

1) Beginning balance of provision for sales returns (end of 2008, beginning of 2009)

2) Company estimates for sales returns for 2009

3) Amount of sold goods returned in 2009

ii)

1) Dr. Sales returns (I/S) 425 million

Cr. Provision for sales returns (B/S) 425 million

2) Dr. Provision for sales returns (B/S) 443 million

Cr. Accounts Receivable (B/S) 443 million

iii) On Pearson's income statement, sales returns is listed implicitly in Sales, because cost of goods sold is not subtracted until net sales have been found. Sales returns can also be listed explicitly, with the income statement listing "Sales − sales returns and allowances = net sales."

H)

	Gross Tade Receivables (in millions)			
1)	£	1,030.00		
2)	£	5,624.00		
3)			£	20.00
4)			£	443.00
5)			£	5,202.00
	£	989.00		

1) Beginning balance for gross trade receivables in 2009
2) Credit sales (we are told that all sales are made on account)
3) Write-offs of accounts that are deemed uncollectible
4) Sales returns
5) Collected accounts receivable (converted into cash)

Sales on account (2)

Dr. Accounts receivable 5,624 million

Cr. Sales revenue 5,624 million

Accounts receivable collection (5)

Dr. Cash 5,202 million

Cr. Accounts receivable 5,202 million

I)

***Note**: Trade receivables balance and accounts estimated uncollectible are both listed in millions.

	Trade receivables balance	Estimtaed % uncollectible	Accounts estimated uncollecti
Within due date	1,096	2%	21.92
Up to three months past due date	228	4%	9.12
Three to six months past due date	51	25%	12.75
Six to nine months past due date	20	50%	10
Nine to 12 months past due date	4	60%	2.4
More than 12 months past due date	20	90%	18
Total	1419	5.23%	74.19

Based on this estimate, the auditor for Pearson would be comfortable with the 76 million balance in provision for bad and doubtful debts. This aging schedule estimate is roughly 1.8 million below the balance in provision for bad and doubtful debt, which provides a little bit of "cushion" and shows that Pearson's estimates for uncollectible accounts are fairly accurate.

J)

$$\text{Accounts receivable turnover} = \frac{\text{credit sales, net}}{\text{average gross accounts receivable}}$$

***Note**: Average the current and previous years' gross accounts receivable to find the denominator.

$$\text{Average collection period (in days)} = \frac{365 \text{ days}}{\text{Accounts receivable turnover}}$$

See the next page for the breakdown of these ratios in Pearson's business.

	2009	2008
Credit sales, net	5,624	4,811
Average gross trade receivables	1446.5	1282.5
Accounts receivable turnover	3.89	3.75
Average collection period	93.83	97.33

Both sales and average accounts receivable increased in 2009 compared to 2008. Because the company's accounts receivable turnover also increased, their average collection period dropped by about 4 days.

K) There are a few possible options for reducing Pearson's average collection period:

- Stricter credit policies on who can and cannot pay on credit (this may be a difficult option for an international company like Pearson, but plausible nonetheless).
- Shorter credit payment periods; for example, requiring cash payment within 30 days instead of 60 days.
- Sales discounts for timely payment of the amount owed.

Graphic Apparel Corporation

Analysis of GAC's efficiency and accounting methods

Warren Ball

11/4/2015

Executive Summary

As a young and inexperienced business owner who recently took over her former boss' business, Nicki is in need of some expert advice on not only GAC's financial statements but also on GAC's business cycle efficiency as a whole. Under Nicki's ownership, GAC switched from equity financing to debt financing, taking out a loan with a covenant agreement that GAC maintain a current ratio of at least 1.0. GAC's current ratio could decrease depending on the changes in accounting methods that will be discussed below; therefore, it is important for Nicki to understand how GAC's current ratio can be affected so that she can assure the ratio remains above 1.0. The explanations below will explain certain characteristics of GAC's business as well as changes that need to be made in the company's accounting methods.

1.

   a. Nicki took over ownership of GAC in January 2014.
   b. Before Nicki took over, only the IRS used GAC's financial statements. However, Nicki took out a loan and pledged assets as collateral, so now the bank and the IRS use GAC's statements.
   c. Because GAC switched from equity financing to debt financing through Nicki's loan, the bank now finances GAC.

2.

a. So far, the company is doing well. In a short time period, Nicki's creativity and effort increased the company's fall orders from $100 in 2013 to $10,000 in 2014.
b. GAC sells standard shirts to retailers and custom-ordered shirts to local organizations and sports teams.
c. Even though the company lost some of its long-standing customers due to Nicki's new, edgier shirts, Nicki has successfully secured new business from young, start-up companies while also retaining some of GAC's original clients.
d. The warehouse had a leak in the roof that did not permanently damage the building, but it did cause stains and water damage in about half of the plain shirts ordered for the 2014 season.

3. The revenue recognition principle says that revenues should be recognized in the same period of the expenses that are incurred to create these revenues. GAAP indicates that revenue should be recognized when the good has been delivered or the service performed.
4. GAC reports revenues from its custom orders when a signed order and payment is received from the customer, which isn't acceptable under GAAP. This method of recognizing revenue would apply to dealings with local organizations or sports teams, etc.
5. The alternative point of recognition would be at the point of delivery (performance obligation met).

6. Recognizing revenue at the point of delivery (like GAC does with retail shirts) is the better option for custom shirts. Why? Because custom shirts are ordered with specific design qualifications, there is more room for customer dissatisfaction and production errors.
7. Recognizing revenue at the point of delivery for custom shirts would increase liability during the period between payment and delivery (unearned service revenue) and therefore decrease GAC's current ratio (current liabilities increase).
8. GAAP requires accounts receivable be reported at net realizable value (NRV) = accounts receivable (A/R) – allowance for doubtful accounts (ADA).
9. GAC uses the direct write-off method, which writes off bad debts as they occur. This method is not supported by GAAP and is only acceptable when bad debts are immaterial or cannot be estimated reliably. Since GAC's bad debts are estimable, Nicki should use the allowance method.
10. Because the bank now uses GAC's financial statements, they must be reported under GAAP standards.

$$\text{Average collection period} = \frac{365 \text{ days}}{\text{Accounts receivable turnover}}$$

$$\text{Average collection period (2014)} = \frac{365}{7.58} = 48.15$$

$$\text{Average collection period (2013)} = \frac{365}{10.97} = 33.27$$

The average collection period in 2014 is about 15 days longer than in 2013, suggesting that GAC's new customers are possibly less reliable; therefore, it is safe to assume that the NRV of GAC's receivables is less than it was in 2013.

11. GAC could use the allowance method or, more specifically, the aging-of-accounts method. The aging-of-accounts method better estimates the amount of receivables that will be uncollectible, which will definitely apply to GAC with their increase in average collection period.
12. See #11. GAC should use the aging-of-accounts method.
13. The aging-of-accounts method would increase the allowance for doubtful accounts' balance and subsequently decrease receivables. This change in method would decrease GAC's current ratio (decreasing current assets).
14. GAC recognizes sales returns at the end of the summer, at which point they fully refund all shirts returned by the retailers. GAC does not currently estimate sales returns, which is not acceptable under GAAP standards. GAC should estimate its sales returns by creating a "Sales returns and allowances" account, which is a contra-revenue account.
15. The leak in GAC's warehouse roof damaged (stained) around 50 percent of the shirts that GAC purchased for the fall, increasing the chance that those shirts will be returned by end customers; Nicki also saw a lot of her shirts on the clearance rack at various department stores, which makes her worry that her shirts possibly went unsold.
16. GAAP recommends estimating the amount of returns and then creating an allowance for sales returns and allowances account to offset these returns.

17. GAC should consider the alternative listed in #16. Sales returns are definitely material to GAC's key external user (the bank): returns decrease revenue and provide a more accurate picture of the company's net sales and product reliability.
18. In my opinion, the allowance method is best for estimating returns. For a company like GAC with t-shirts as its main product, returns are a natural part of business. Also, GAC fully refunds all sales returns, which only gives customers more incentive to return shirts. These two factors make sales returns all but inevitable; therefore, the allowance method is better.
19. Sales would decrease because of the contra-revenue account "sales returns and allowances." Sales returns will increase inventory and decrease accounts receivable (or cash if it has already been paid). The current ratio will not be affected because the current assets will decrease (decrease in A/R) by the same amount that they increase (increase in inventory).
20. GAAP reports inventory at lower-of-cost-or-market (replacement cost).
21. GAC uses the lower-of-cost-or-market method, which is acceptable under GAAP and is an appropriate choice for inventory valuation.
22. Nothing has changed this year that suggests GAC should change their method. Goods sold will still be subtracted from inventory and the remaining inventory will still be valuated at lower of cost or market.

$$\text{Number of days to sell inventory} = \frac{\text{Inventory}}{\text{Cost of goods sold}} * 365$$

$$2014 = \frac{24{,}500}{93{,}000} * 365 = 96.16$$

$$2013 = \frac{9{,}000}{81{,}000} * 365 = 40.56$$

These numbers indicate that GAC is taking almost 2 more months to sell its inventory in 2014 than in 2013. This large increase in days to sell inventory could be attributed to 2 possible factors: 1) the company is holding roughly $15,000 more in inventory in 2014 than in 2013; 2) GAC has less demand for its new, edgier products.

23. Shirts that incurred water damage will have to be marked down below cost because of impairment which will cause a loss for GAC. GAC's gross profit for 2014 is 48.32% of net sales; this percentage indicates that GAC sells its shirts at roughly double the price that it takes to produce them.
24. GAC should continue to report its inventory at lower-of-cost-or-market, but a note should also be included on the balance sheet that details the water damage to the shirts from the warehouse leak.
25. Reporting the impairment of GAC's shirts from the warehouse leak would decrease current assets (inventory) and therefore decrease GAC's current ratio.
26. The changes in accounts receivable, inventory, and unearned service revenue would decrease GAC's current ratio. The chart below estimates the numerical changes in GAC's current ratio based on changes to GAC's accounting methods as well as events occurring within the company.

	Current Assets	Current Liabilities
Beginning balance	61,000	45,180
1) Water damage to shirts	(6,125)	
2) Sales returns from retailers	0	
3) Lost A/R from new customers	(3,000)	
4) Unearned service revenue		10,000
Adjusted balances	51,875	55,180

1) GAC states that half of the shirts purchased for 2014 incurred water damage; however, these shirts were still used despite the damage. Estimates suggest that water damage depreciates the shirts roughly 50 percent. So, the loss due to water damage is estimated with the following calculation: $\left(\frac{24,500}{2}\right) * 50\% = 6,125.$
2) Nicki estimates that all shirts held by retailers at the end of August are worth about $15,000. Receiving these returned shirts would decrease A/R by $15,000 (full refund), but inventory would also increase by $15,000. Therefore, there is zero change in current assets.
3) Nicki is ready to give up on $3,000 of A/R from new customers who seem to be having a problem with GAC's sales terms of n/30. These doubtful accounts will decrease current assets.
4) By recognizing revenue when the service obligation is met instead of at the point of order, GAC's sales orders of $10,000 become $10,000 of unearned service revenue instead of service revenue.

27. Based on GAC's 2014 balance sheet, the company's current ratio is 1.35 ($61,000/$45,180). However, multiple events (listed in #26) have occurred within the company that suggest GAC's current ratio will decrease. Based on these

events, GAC's new current ratio is estimated to be .94. To return to a current ratio of 1.0, Nicki would need to contribute at least $3,305 in additional equity.

28. First of all, Nicki needs to make sure that all of her financial accounting methods are in line with GAAP standards, which they will be if Nicki implements the suggested changes in valuation methods. Also, Nicki needs to eliminate GAC's full refund policy on returned shirts; this change may decrease customer goodwill, but ultimately a t-shirt company will not survive giving full refunds due to the amount of returns that will be made annually.

Analysis of Northwest, Delta, United, and Waste Management

By: Warren Ball

Part A

Part A of the analysis contains an in-depth look at the depreciation and sales schedules of three large airlines: Northwest, Delta, and United. First, a look at a table with relevant financial information for all the companies:

	Northwest	Delta	United
Book Value 1/1/05	75,000,000	75,000,000	75,000,000
Residual	3,750,000	3,750,000	3,750,000
Depreciable Amount	71,250,000	71,250,000	71,250,000
Useful Life	14,500,000	20,000,000	27,500,000
Annual Depreciation	4,913,800	3,562,500	2,590,000
Acc. Depreciation 12/31/08	19,655,200	14,250,000	10,360,000
Book Value 12/31/08	55,344,800	60,750,000	60,890,000
Sale Price I	55,000,000	60,000,000	65,000,000
Gain (Loss) on Sale I	-343,800	-750,000	4,110,000
Sale Price II	60,000,000	60,000,000	60,000,000
Gain (Loss) on Sale II	4,655,200	750,000	890,000

One might be curious why the airlines depreciate this equipment at different rates. The answer to this is twofold: tax implications and truer representation. First, the tax implications can be large from deciding how to depreciate large amounts of equipment. The larger the net income, for example, the larger the taxes. Therefore, to bring that net income number down, a company can depreciate a piece of equipment more rapidly if it wants to recognize less profit. Second, companies might depreciate the same equipment differently because of levels of use. One company might use a piece of equipment more frequently than another, which means depreciating the equipment quickly would make more sense.

Furthermore, Sales Price II probably makes more sense for all of the companies, for it creates more of a market for the plane. Sales price I has too much variation to truly be successful. By starting all of the planes at the same price, companies can make the necessary adjustments when the market changes for their specific plane.

Part B

Waste Management had a laundry list of charges. They were accused of concealing the operating realities of the company by making or authorizing misleading statements. The top executives of Waste Management did this in order to meet earnings goals, which would allow them to retain their positions and retirement benefits. Moreover, the stock was inflated, and the executives were accused of selling off the stock knowing of this inflation. Lastly, the complaint states that the profits were overstated by 1.7 billion dollars

One of the main ways that Waste Management nefariously managed their earnings was by utilizing depreciation expense. They deferred their current period expenses, which incorrectly inflated their income for the current period. Also, they avoided the depreciation expense by extending the estimated useful life of the trucks while also making unsupported increases to the trucks' salvage value. In other words, the older that

the trucks got, the more they appreciated in value, which is obviously a backwards proposition on almost any piece of equipment.

The reasoning behind inflating the earnings of Waste Management is really quite simple: the executives wanted to make sure that everyone thought they were doing a great job in turn to keep their job positions. In keeping these positions, they would reap the benefits of an executive salary as well as performance based benefits and retirement programs. In other words, the management team wanted to make sure that their money kept coming in, and they out their integrity in the process.

Arthur Andersen was also a large part of this disaster, since they were the auditor. The evidence against Arthur Andersen was pretty convincing: it seemed they were helping to produce the false and misleading reports, and they would not stand up to the managers of Waste Management to tell them that their financial statements were not fair and reasonable. This fact could be a product of 14 Waste Management employees previously worked at Arthur Andersen. Arthur Andersen eventually settled for 7 million dollars, but they never admitted guilt outright. Arthur Andersen continued to have struggles with integrity within the financial statements, and they eventually disbanded after many pending lawsuits.

Rite Aid Corporation

Analysis of Rite Aid's long-term debt and reporting methods

Warren Ball III

2/3/2016

The University of Mississippi

Executive Summary

In this report, we have analyzed Rite Aid's long-term debt and the different methods of accounting for this debt. Looking at a company's long-term debts and some of the financial ratios associated with them can help you get a better feeling for the company's stability and long-term outlook. Below, you will find information regarding the different aspects and forms of Rite Aid's long-term debt and what some of these factors might have to do with the company's credit rating.

***Note**: All numbers provided in this report are in thousands (add three zeros to the numbers given).

A)

1. Secured debt is backed by the borrower's (Rite Aid's) pledge of collateral, whereas unsecured debt is not backed by collateral and is therefore riskier for the lender. These unsecured debts also carry higher interest rates. Because of these differences, it is important to distinguish between these two types of debt for any company, including Rite Aid.

2. "Guaranteed" debt means that a third party has backed the borrower in case the borrower defaults on their payment; a guarantee is basically collateral in the form of another company. In Rite Aid's case, the parent entity is guaranteeing the unsecured debt of Rite Aid's subsidiaries.

3. Convertible debt is when a company borrows money from investor[s] with both parties intending on the debt being converted to equity at a later date. This date is usually specified at the time of borrowing. A “fixed-rate” bond has equal interest payment amounts over the course of its full life. “Senior” debt or loans imply that these borrowings take higher priority in the company’s financial structure; in other words, the company will pay these debts before other unsecured debts.

4. Differences in interest rates and debt payment structures are inherent as multiple subsidiaries and branches of Rite Aid deal with different lenders.

B) On February 27th, 2010, Rite Aid has $6,370,899 in total debt. Of this amount, $51,502 is the currently maturing portion. This total debt is made up of three accounts on the balance sheet: current maturities of long-term debt ($51,502), long-term debt less current liabilities ($6,185,633), and lease financing obligations less current maturities ($133,764).

C)

1. The face value of these notes is $500,000. We know this because no premium or discount is mentioned and the face value does not change over time.

2. Dr. Cash 500,000

Cr. Bonds Payable 500,000

3. Dr. Interest Expense 37,500

Cr. Cash 37,500

4. Dr. Bonds Payable 500,000

Cr. Cash 500,000

D)

1. The principal value of the notes is $410,000; however, the carrying value of the notes is $405,951. The reason for the notes' lesser carrying value is due to unamortized discounts of $4,049.

2. During the 2009 fiscal year, Rite Aid paid interest on the note in the amount of $38,438 (410,000 * .09375).

3. Rite Aid incurred $39,143 in total interest expense for the 2009 fiscal year. Of this amount, $705 is noncash interest (38,438+705)

4.

Interest Expense		39,143	
	Discount		705
	Cash		38,438

5. Total rate of interest recorded= $\frac{39,143}{405,951} = 9.64\%$

E)

1.

Cash		402,620	
Discount		7,380	
	Bonds Payable		410,000

Note: carrying value= (410,000 .982) = 402,620

2. These notes were issued at an effective annual interest rate of 10.1212%. The following values were put into the RATE function on Excel to obtain this interest rate: number of periods (7), cash interest payments (39,975), present value (402,620), and future value (410,000).

3.

Date	Interest Payment	Interest Expense	Bond Discount Amortization	Net Book Value of Debt	Effective Interest Rate
30-Jun-10	$39,975	$40,750	$775	$403,395	10.1212%
30-Jun-11	$39,975	$40,828	$853	$404,248	10.1212%
30-Jun-12	$39,975	$40,915	$940	$405,188	10.1212%
30-Jun-13	$39,975	$41,010	$1,035	$406,223	10.1212%
30-Jun-14	$39,975	$41,115	$1,140	$407,363	10.1212%
30-Jun-15	$39,975	$41,230	$1,255	$408,618	10.1212%
30-Jun-16	$39,975	$41,357	$1,382	$410,000	10.1212%

4.

Interest Expense		27,167	
	Discount		517
	Interest Payable		26,650

5. The net book value of the notes on February 27, 2010 is $403,137 (402,620+517).

6.

Date	Interest Payments	Interest Expense	Bond Discount Amortization	Net Book Value of Debt	Straight-Line Rate
30-Jun-09				$402,620	10.1905%
30-Jun-10	$39,975	$41,029	$1,054	$403,674	10.1639%
30-Jun-11	$39,975	$41,029	$1,054	$404,728	10.1374%
30-Jun-12	$39,975	$41,029	$1,054	$405,782	10.1111%
30-Jun-13	$39,975	$41,029	$1,054	$406,836	10.0849%
30-Jun-14	$39,975	$41,029	$1,054	$407,890	10.0588%
30-Jun-15	$39,975	$41,029	$1,054	$408,944	10.0329%
30-Jun-16	$39,975	$41,029	$1,054	$409,998	10.0071%

7. Under the effective interest method, the interest expense increases each year, whereas the expense remains constant under the straight line method. The largest difference between the two methods occurs in 2016, when Rite Aid accounts for $328 more interest expense under the effective interest method compared to the straight line method. On the surface, this may seem like a big difference; however, when accounting for the company's total interest expense on the notes, this amount becomes immaterial.

F)

1.

Notes Payable		810,000	
	Cash		797,769
	Discount		8,481
	Gain		3,750

2. Rite Aid did not have to repurchase the notes at face value because the notes still had unamortized discounts attached to them; also, the market rate may have been lower than the face rate of these notes at the time of Ride Aid's repurchase.

3. The market rate is lower than both the 9.5% coupon rate and the effective rate, giving Rite Aid the ability to repurchase the notes at a gain of $3,750.

G)

1. Companies issue convertible debt because they can eventually convert the debt into equity. Also, companies can offer these bonds at a lower coupon rate than they would be able to offer on the open market which saves money on interest payments. These lower rates are one of the reasons young, growing companies might issue convertible bonds. On the other hand, investors buy these bonds because they offer the security of a bond with the potential opportunity for a huge gain if the company's stock price increases and the investors' bonds are converted. On the balance sheet, convertible debt would translate from a liability to an equity account (shares of common stock, for instance).

H)

1.

Ratio	Definition	Industry Average	Rite Aid FY2009	Rite Aid FY 2008
Common-Size Debt	Total Liabilities / Total Assets	43.83%	82.79%	87.41%
Common-Size Interest Expense	Interest Expense / Net Sales	0.35%	2.01%	1.82%
Debt-to-Assets	Total Long-Term Debt / Total Assets	14.41%	79.14%	72.20%
Long-Term Debt to Equity	Total Long-Term Debt / Total Shareholders Equity	0.26	-3.81	-5.01

Proportion of Long-Term debt due in 1 year	Long-Term Debt due in 1 year / Total Long-Term Debt	6.11%	0.81%	0.68%
Times-Interest-Earned "Interest Coverage"	(Pretax income + Interest Expense) / Interest Expense	33.44 x	-6.95	-4.41

2. The thing that stands out about Ride Aid is the sheer amount of liability and debt that the company holds. Rite Aid's common-size debt ratio is roughly double that of their competitors and their debt-to-assets ratio is almost five-times that of their competitors'. Also, Rite Aid is not generating any profit.

3. Rite Aid is operating at a net loss with an accumulated deficit for their stockholders. Overall, the company does not appear to be in ideal financial condition and must find a way to start generating profit to pay off their vast long-term debts. If the company continues on its current path, Rite Aid will be unable to pay off its debts in the coming years.

I) I would give Rite Aid a credit rating of B. While the company may technically be able to meet their interest payments for the next few years, Rite Aid is in a vulnerable position due to its inefficient operations. The solution is simple: if Rite Aid can improve its operations and start generating profit, their long-term outlook for paying off their debts will greatly improve, as is the case with any company.

Merck & Co., Inc. and GlaxoSmithKline plc

Analysis of Equity and reporting methods

By: Warren Ball

The University of Mississippi

Executive Summary

Below you will find a variety of information regarding equity and the nuances of accounting for it: differences in disclosure methods under U.S. and International GAAP, reasons for paying dividends and purchasing treasury stock, etc. Merck & Co. (Merck) and GlaxoSmithKline (GSK) are the two companies analyzed below.

A)

i. Merck is authorized to issue 5,400,000,000 stocks.

ii. Merck has issued 2,983,508,675 shares as of December 31st, 2007.

iii. $2{,}983{,}508{,}675(shares\ issued) * .01\ (par\ value) = 29{,}835{,}087$

iv. As of December 31, 2007, Merck holds 811,005,791 shares in treasury stock.

v. The difference between issued stock and outstanding stock will usually come from a company purchasing treasury stock; otherwise, shares outstanding will be equal to shares issued. In Merck's case, the number of shares outstanding is simply their issued shares less their treasury shares (2,983,508,675 – 811005791 = 2,172,502,884).

vi. Market Capitalization= Shares outstanding * price per share.

Market Capitalization= 2,172,502,884 * $57.61= 125,157,891,147

B)

i. GlaxoSmithKline is authorized to issue 10,000,000,000 ordinary shares.

ii. As of December 31, 2007, GlaxoSmithKline has actually issued 6,012,587,026 ordinary shares.

iii. 5,373,862,962 shares are in free issue as of December 31, 2007.

iv. 504,194,158 Treasury shares are held by GlaxoSmithKline at December 31, 2007.

v. Share capital is simply the book value of your stock (number of shares * par value). Share premium is the excess market value of these shares over their par values. As a subscriber to U.S. GAAP, Merck calls these accounts common stock (share capital) and other paid-in capital (share premium account).

C) Companies pay dividends in order to reward their shareholders for their investments in the company while simultaneously providing a certain degree of certainty about a company's financial well-being. Also, another positive of high dividend payouts is that these dividends may attract other investors. These dividend payouts also affect a company's stock price. Stock price is basically the present value of all expected future dividends, so when a company pays out dividends, the company's stock price drops.

D) Companies may repurchase shares for a variety of reasons.

- A company's EPS increases when the company repurchases shares (earnings are divided among fewer shares outstanding).
- If a company believes their stock is undervalued, they may repurchase their stock, wait for the price to climb, and then resell the stock.
- If a company fears takeover from an outsider, they will repurchase shares to secure their majority ownership of the company so that an outsider will be unable to take over the company through the market.

E)

Dividends Declared		$	3,310,700.00		
	Cash			$	3,307,300.00
	Dividends Payable			$	3,400.00

F)

i.

Dividends Declared		£	2,793,000.00		
	Cash			£	2,793,000.00

ii. Because of IFRS, GSK records dividends in the financial statements when they are paid, not when they are declared. Because GSK usually pays their dividends two quarters after the quarter to which the dividends relate, you simply add up the dividends paid in the last two quarters of 2006 and the first two quarters of 2007 (671+785+670+667=2793) (millions).

G)

i. Merck uses the cost method in accounting for this treasury stock rather than using par value. The cost method means that Merck will record the value of this treasury stock at the value for which these shares were repurchased on the open market.

ii. Merck repurchased 26.5 million shares during 2007 on the open market.

iii. In total, Merck paid 1,429.7 million to repurchase its stock during 2007, paying an average of $53.95 per share. Buying back shares is considered a financing activity on the cash flow statement.

iv. Although Merck can improve their cash flow by repurchasing and then reselling their stock, they technically cannot disclose treasury stock as an asset because they are dealing within their own equity (treasury stock is a contra-equity account). Classifying treasury stock as an asset would create false financial value for the company.

H)

i. During 2007, GSK repurchased 285,034,000 shares on the open market. Some of these shares were not held in treasury: of the shares purchased in 2007, 269 million are held in treasury and 16 million have been cancelled.

ii. On average, GSK paid £13.09 per repurchased share.

iii. Under U.S. GAAP, this “Movements in equity” account is referred to as “Statement of Stockholder’s Equity.”

Retained Earnings		£ 3,750,000,000.00	
	Cash		£ 3,750,000,000.00

I)

(in millions)	Merck 2007	2006	Glaxo 2007
Dividends Paid	$ 3,307.30	$ 3,332.60	£ 2,793.00
Shares Outstanding	$ 2,172.50	$ 2,167.79	£ 5,373.86
Net Income	$ 3,275.40	$ 4,433.80	£ 6,134.00
Total Assets	$ 48,350.70	$ 44,569.80	£ 31,003.00
Operating cash flows	$ 6,999.20	$ 6,765.20	£ 6,161.00
Year-end stock prices	$ 57.61	$ 41.94	£ 97.39

	Merck 2007	2006	Glaxo 2007
Dividends per share	$ 1.52	$ 1.54	£ 0.52
Dividend yield	3%	4%	1%
Dividend payout	1.01	0.75	0.46
Dividends to total assets	0.07	0.07	0.09
Dividends to operating cash flows	0.47	0.49	0.45

Merck’s dividends per share, dividend yield, and dividends to operating cash flows all decreased from 2006-2007, but their dividend payout increased significantly. Comparing

the two companies shows that GSK has significantly lower dividends per share, dividend yield, and dividend payout than Merck; however, GSK appears to manage their total assets more effectively, and they have similar operating cash flows to Merck.

State Street Corporation

Analysis of Marketable Securities

By: Warren Ball

The University of Mississippi

A)

i. Trading securities are debt or equity investments that are held for a year or less to produce a short-term profit.

ii. A company would recognize dividends or interest from trading securities by recording a receivable (dividend/interest receivable) and eventually a cash receipt which will take the receivable off the books.

iii. The entry to record an increase in the fair market value of trading securities involves a debit/credit to Unrealized Holding Gains – Income, which eventually shows up on the Accumulated Other Comprehensive Income statement.

B)

i. Available-for-sale securities are investments that are not classified as either trading securities or held-to-maturity securities. These securities are reported at fair value, with changes in value being reported under comprehensive income.

ii. The entry to record dividends or interest receivable from available-for-sale securities is similar to the entry for trading securities (entry Aii).

iii. The entry to record an increase in FMV is like that of trading securities. An unrecognized holding gain or loss is reported under comprehensive income.

C)

i. Investments that are held to maturity are similar to the other types of trading securities, except that the purpose of these is to hold them until they reach their maturity date. No changes in FMV are reflected in these investments. Equity investments cannot be classified as held to maturity because they have no maturity.

ii. Held for maturity securities are recorded at their amortized cost over their life until their maturity date. No changes in market value are recorded.

D)

i. The account balance in "Trading account assets" is 637 million, which is also the market value because State Street Corporation carries their trading account assets at fair value.

ii.

Trading account assets	85	
Unrealized holding gain- income		85

E)

i. The 2012 year-end balance in "investment securities held to maturity" is 11,379 million.

ii. The market value of these securities is 11,661 million.

iii. The amortized cost of these securities is 11,379 million. The amortized cost represents the face value less the accumulated amortized premium or discount. The amortized cost will slowly converge to the maturity amount over the course of the investment's life.

iv. The difference between market value and amortized cost is a change in the market rate for these securities. A higher market value means that the rates on these securities have risen since they were purchased by State Street.

F)

i. The 2012 year-end balance in "investment securities available for sale" is 109,682 million; this amount represents the market value of the securities.

ii. At December 31, 2012, State Street has 2,001 million in unrealized gains and 882 million in unrealized losses. These amounts result in a net gain of 1,119 million.

iii. State Street realized a 55 million gain from sales of available-for-sale securities. This gain increases both the company's income and its cash flows because the gain is realized.

G)

i.

Investments available for sale	60,812	
Cash		60,812

ii.

Available for sale securities	67	
Unrealized holding gain		67

Cash	5339	
Available for sale securities		5339

iii. The original cost of the available for sale securities is $61,601 million, which is the difference between $67 million and the $5339 million from the proceeds of the sale.

iv.

Net unrealized gain (loss) on AFS Securities

181	
67	
	1367
	1119

Adjustments to AFS for FMV	1,367	
Unrealized holding gains		1,367

These unrealized holding gains and losses for 2012 would not impact State Street's cash flows at all; even though these changes in fair market value could eventually result in a smaller or larger cash flow at the time of sale, they have no current impact on cash flows.

Groupon

Analysis of revenue recognition, returns, and risk

Warren Ball

The University of Mississippi

1. Groupon is more of an "e-tailer" than a traditional retailer, selling discount coupons to customers without actually participating in the exchange of the materials or services. Groupon also appears to be mostly concentrated on maximizing revenue. Walmart and Amazon, on the other hand, are more traditional retailers: Amazon holds goods from many different suppliers and sells them online, while Walmart physically sells the goods both in large department stores and online. These companies also appear to concentrate more on the customer experience rather than maximizing revenue, which may have to do with the fact that these companies are older and more established than the young and growing Groupon.

As far as risk factors, these companies share many common risks considering that they are all competing in the same industry. For financial reporting purposes, these companies have many concerns, including the need to be careful in how recognition of revenue is reported as well as how they are going to account for allowances. Let's use Groupon for both examples: Groupon is recognizing revenue before the goods and services they promise are even delivered, and they have no historical data with which to estimate their allowances. In both cases, the company should be careful in how they report these values.

2. Although the trends in Groupon's stock price follow the company's income more so than revenue (see chart on top of next page), revenue growth is more important than income growth for this new business because of what these accounts signify to external sources. A young company that has steadily increasing revenue is showing the capability to attract more of the market, something that is inherently important to a young company trying to compete for market share. Because of this, revenue growth is irreplaceable: without enough revenue, a company's gross margin becomes immaterial. On the other hand, income growth, while also very important, is a little bit more "fixable." Income can be enhanced by greater efficiency in the business process and mitigating costs, things that a young company can learn as they grow; the product or service that launches the company's revenue growth is most important.

Another factor to consider is that Groupon is taking on net losses in these early growth years, which makes stock price difficult to compute. So, even though income will eventually become more important as it affects stock price, as a young company revenue is the most important indicator.

Amazon			
	Revenue	Income	Stock Price
1997	$148	-$31	$5.02
1998	$610	-$124	$53.53
1999	$1,640	-$720	$76.13
2000	$2,762	-$1,411	$15.56
2001	$3,122	-$567	$10.82
2002	$3,933	-$149	$18.89
2003	$5,264	$35	$52.62
2004	$6,921	$588	$44.29
2005	$8,490	$333	$47.15
2006	$10,711	$190	$39.46
2007	$14,835	$476	$92.64
2008	$19,166	$645	$51.28
2009	$24,509	$902	$134.52
2010	$34,204	$1,152	$180.00
(in millons except for Stock Price)			

3.

Common Size Income Statements				
	2009		2010	
	Gross	Net	Gross	Net
Revenue	100%	100%	100%	100%
COGS	64%	30%	61%	10%
Gross Margin	36%	70%	39%	90%
Marketing Expense	15%	34%	37%	91%
G&A Expense	25%	44%	33%	68%
Other Expenses			28%	65%
Net Loss	-4%	-8%	-58%	-134%
Net Loss to common shareholders	-23%	-48%	-64%	-146%
EPS (basic)	-$0.04	-$0.04	-$2.66	-$2.66

	2009		2010	
	Gross	Net	Gross	Net
Gross Margin	36%	70%	39%	90%
Total assets	14962	14962	381570	381570
Total asset turnover	2031.81	969.12	3598.20	1578.18

Converting to the net method had opposite effects on Groupon's gross margin and total asset turnover. Groupon's gross margin nearly doubled under the net method, a very positive statistic for Groupon; on the other hand, the company's total asset turnover decreased by over 100% in both years under the net method due to recognition of far less net sales.

4.

A) Originally, Groupon was reporting its revenues under the gross method, reporting all of their customer sales as revenues without regard to repaying the provider of goods/services a portion of those revenues. After adjustments following the SEC filings, Groupon started reporting under the net method, which recognizes revenue as the difference between what the customers paid Groupon and what Groupon paid to the suppliers.

B) Groupon obviously preferred the gross method; their revenues under the gross method are over twice the amounts under the net method. This is important for Groupon because revenue size and growth is a key indicator of success for a young company.

C) Groupon argued that they were the “primary obligor” in these business transactions by providing these coupons to customers for the suppliers, also stating that the credit risk Groupon takes on through “The Groupon Promise” supports their position as primary obligor.

D) They aren’t the primary obligor; their Terms & Conditions even states that Groupon is in no way responsible for the good and services provided by the merchant because the merchant is the issuer of the voucher.

5.

E) When the right of return exists for the customer, the company is supposed to recognize revenue at the expiration of that right; however, Groupon recognizes revenue immediately upon the sale of its coupons with no historical way to estimate returns, creating a risky reporting situation for the company should a material amount of goods be returned.

F) Groupon’s accounting is incorrect. Their unconditional promise to accept any returned goods makes it incredibly difficult to estimate the amount of returns they will have, especially in unfamiliar, “high-ticket” markets. The result was Groupon having to restate its 2011 financial statements by decreasing the following accounts:

-Revenues (14.3 million)

-Operating income (30 million)

-Net Income (22.6 million)

-EPS (.04)

G) Groupon could have reduced their credit risk by implementing a policy that limited the return period (30-60 days for example). This would also allow them to estimate their annual returns more accurately.

6. The restatement of these accounts relates to Groupon's decision to increase its refund reserve accrual, which affected income related items but did not affect cash flow.

Construct

Analysis of Financial Position through GAAP and IFRS

By: Warren Ball

The University of Mississippi

Summary

The questions below are answered through both GAAP and IFRS standards.

Question 1: In 2007, at the time of purchase, should construct record a liability for environmental liabilities? If so, how much?

A: No liability should be recorded for two reasons: first, Construct has not even been notified of a potential liability regarding environmental damage; if they had known of this liability, they probably wouldn't have purchased the tract of land in the first place. Secondly, even if Construct had hypothetically known of this potential liability, the liability was not reasonably estimable at the time and therefore would not be recorded.

Question 2: In 2008, should the company record any liability due to BigMix filing for Chapter 11? If so, how much?

A: Construct should not record a liability for this event, even if they are trying to secure an interest in BigMix's shareholders' assets. BigMix's bankruptcy filing occurs after Construct purchases the land. So, technically, Construct has no liability tied to BigMix's bankruptcy.

Question 3: In 2009, should the company record any liability for the potential environmental liability? If so, how much?

A: Construct should record a liability in this situation. The liability is likely to be incurred (60%) and can be reasonably estimated ($250,000).

Question 4: In 2010, should the company record any liability for the potential environmental remediation? If so, how much?

The company should book a liability in total of $400,000, $100,000 from estimated legal fees for administering the remediation action and $300,000 from the study itself. Construct should also use a supplementary note to disclose possible further liability since the total cost of the remediation effort cannot be reasonably estimated.

Question 5: In 2011, should the company record any additional liability for the potential environmental remediation?

Construct should record a liability of $1.5 million for the estimated costs of the remediation plan. If Construct does not go through with this remediation plan, harsh financial consequences will follow from the EPA.

Question 6: In 2012, should the company record any gain contingency or contingent asset for the potential settlement?

Gain contingencies are not reported until the gain is realized, even if they are probable. In this case, Construct should disclose the possible $1 million gain in a footnote.

ZAGG Inc. - Zealous About Great Gadgets

Analysis of Deferred Income Taxes

Warren Ball

The University of Mississippi

Summary

In the explanations below, you will find various pieces of information regarding deferred income tax accounting. For example, a few of the topics covered are: 1) using deferred tax assets and liabilities to interpret differences in book versus taxable income, 2) understanding the effects of changes in income tax rates, and 3) understanding the underlying concepts for deferred income tax accounting.

A) Book income is the income that is reported on a company's financial statements. For ZAGG, $23,898,000 in the "Income before provision for income taxes" account represents book income. Tax income can differ from book income for a couple of reasons: 1) permanent differences (such as non-taxable income or fines) and 2) temporary differences, which will either result in deferred tax assets (DTA's) or deferred tax liabilities (DTL's).

B)

i) As was briefly discussed above, permanent tax differences are differences that will not be reversed. Some revenues on the financial statements are not taxable, just as some

expenses are not deductible. An example of a permanent difference is a fine for pollution, which is a non-deductible expense that is reported on financial statements.

ii) Temporary tax differences are differences that can and will be reversed. Temporary differences arise from expenses and/or revenues that are recognized in different periods for financial statements and tax purposes. However, they will eventually be recognized in either case, which "reverses" the difference. For example, company can use accelerated depreciation for taxes and straight-line depreciation for its books. This results in taxable income being lower than straight-line in the first few years.

iii) The statutory tax rate is the government-imposed tax rate.

iv) The effective tax rate is computed as follows: divide the taxes paid by the book income, which will reveal the actual percentage amount of income paid out in taxes.

C) Companies report deferred tax expense in order to fully disclose their financial position. If a company were to avoid reporting these values, it would essentially be misrepresenting their future liabilities, consequently providing an inaccurate picture of their standing to investors, creditors, etc.

D) Deferred tax assets arise when a company has a higher taxable income than book income in the current year; this will result in the company being able to deduct these

amounts on future taxable income. Deferred tax liabilities are taxes that a company does not currently have to pay for but will pay for in future years. An example of a deferred tax liability would be using an accelerated depreciation method for tax purposes, which will decrease your book income more in the current years than in future years (more taxable income in future years). A prepaid tax asset would arise from "prepaid rent," for example. For tax purposes, this rent revenue is immediately recognized, even though it is not recognized on the books; therefore, the company's taxable income will be less than it's book income in future years when the "prepaid rent" is recognized as revenue.

E) When a company has a deferred tax asset that it believes it will not be able to recognize, the company will create a valuation account to offset the DTA's balance. Most of the time, this valuation account is used when a company expects to have insufficient income.

F)

i)

Income tax provision	9393		
Net deferred tax asset	8293		
Income tax payable		$	17,686

ii) The amount recorded in net deferred tax asset was a debit of 8,293. This amount has two parts: a deferred income tax asset and deferred income tax liability. In Note 8, we can see that DTA's increased by 8,002 (debit), while DTL's decreased by 291(debit); this results in a net increase of 8,293.

iii) ZAGG's effective tax rate for 2012 equals 39.30%. To find this percentage, we take the income tax provision and divide it by the "income before provision for income taxes" which gives us the effective rate. The difference between the statutory rate and the effective rate comes from the permanent differences between the taxable income and the book income. The statutory tax rate and effective tax rate can also differ due changes in the statutory rate over multiple years.

iv) GAAP requires a net amount to be listed on the balance sheet for both current and noncurrent tax assets. Net current deferred income tax assets is under current assets and equals $6,912, and net noncurrent deferred income tax assets is under noncurrent assets and equals $6,596. Adding these amounts gives $13,508.

G)

i) In 2012, the tax system recognized a greater depreciation expense. This greater expense resulted in lower taxable income than book income, which gives rise to deferred tax liabilities.

ii) The cumulative difference between the amounts is $2,269.

Cumulative difference in book and tax depreciation expense
$ 2,269
x
Statutory income tax rate
35%
=
Deferred income tax liability relating to property and equipment at 12/31/2012
$ 794

iii) If ZAGG used tax depreciation throughout the assets' lives, the balance of the account at December 31, 2012, would be $1,048. To find this number, take the book value listed net of accumulated depreciation and subtract the cumulative difference between the book and tax depreciation expense.

H)

i) The book system recognized a greater expense for doubtful accounts during 2012, which can be seen by the fact that taxable income is higher than book income. This difference results in future deductible amounts which result in deferred tax assets.

ii) The difference in bad debt expense for 2012 between the book and tax system equals $654.

Current period difference in book and tax bad debt expense in 2012
$ 654
x
Statutory income tax rate
35%
=
Change in the deferred income tax asset relating to the allowance for doubtful accounts
$ 229

I) The amount in the deferred income tax asset valuation account is $713 as of December 31st, 2012. ZAGG created this account to offset losses in their HzO equity investment; the account was created due to uncertainty of future profits and the current state of operations. ZAGG believes that this deferred tax asset will likely not be realized.

J)

Income tax provision	1,930	
Net deferred tax assets		1,930

Johnson & Johnson (J&J)

Analysis of Retirement Obligations

Warren Ball

University of Mississippi

April 19, 2016

Summary

The explanations below will help you interpret the footnotes associated with retirement obligations while also explaining the difference between expensing and funding a retirement obligation. You will also learn how actuarial assumptions effect pension expense, assets and obligations.

A)

i) Defined contribution plans place a specific amount of money in the retirement account each period, while defined benefit plans identify the specific amount of benefit that will be available to you at retirement. Johnson & Johnson uses both types of plans.

ii) Retirement plan obligations are liabilities because they are future payable amounts to retired employees.

iii) Some of the assumptions for retirement plans are 1) life expectancy after retirement for a predicted amount of years 2) how many years they will spend working for the company, and 3) projected salary towards the end of their career.

B) Service costs equal the present value of benefits attributed to employee service during the period. This amount is determined by a pension formula. Interest cost

is simply the interest on that period's PBO outstanding. Actuarial gains or losses come from amortization of OCI gains and losses.

C) Actual return relates to increases in the pension fund due to interest, dividends, and unrealized/realized changes in the fair value of plan assets. Benefits paid are paid by the company handling J&J's pension obligation; they reduce PBO and plan assets. Contributions are cash contributions made by the company to increase the company's plan assets. Benefits paid to retirees reduce plan assets and reduce J&J/s PBO.

D) When actual returns occur, they increase plan assets, but they decrease pension expenses. (expected vs. actual)

E) The difference between these other benefits and the company's retirement plan is that the retirement plan is a sum that has been accumulated and will definitely be available upon retirement. On the other hand, health insurance and other benefits are not pre-determined and can be modified by the company at any time; they are not prepaid.

F)

i) J&J accounted for $646 million of pension expense in its 2007 income statement.

ii)

Pension expense	1,253	
PBO		1,253

G)

i) J&J's retirement plan obligation is $12,002 as of December 31, 2007. The PBO is a reliable number, accounting for changes in fair value, gains and losses, and contributions and expenses. The number equals the present value of projected obligations to employees.

ii) The interest cost is determined by the beginning amount of PBO; based on this calculation, the interest rate is 5.63%. This is a high interest rate compared to industry competitors (Proctor & Gamble, for instance).

iii) The amount of pension benefit paid to retired employees in 2007 was $481 million. This amount is not paid in cash by J&J; rather, it is deducted from plan assets (where cash contributions go) and also decreases J&J's pension liability.

H)

i) As of December 31, 2007, the amount in J&J's plan assets is $10,461 million, which is the fair value of the plan assets at the end of the year.

ii) J&J's 2006 actual return is $265 million greater than expected return, but in 2007 actual return fell short of expected return by $66 million. While J&J's expected

return remained fairly consistent, their actual return fluctuated much more and is a better indicator of the company's actual pension expenses.

iii) 2007 contributions totaled $379 million, with 317 coming from the company and 62 coming from the employees. 2006 total contributions equaled $306 million, with 259 from the company and 47 from the employees.

iv) J&J has both debt and equity securities in its retirement plan assets; in 2007, equity securities accounted for 79% of the portfolio and debt securities the remaining 21%.

I) J&J's retirement plan is underfunded for both 2006 and 2007, with obligations exceeding funding by roughly $10 million in both years. Funding status appears on the balance sheet in non-current assets, current liabilities, and non-current liabilities